



Signed and Filed: June 29, 2012

A handwritten signature in dark ink, appearing to read "T. E. Carlson".

THOMAS E. CARLSON
U.S. Bankruptcy Judge

UNITED STATES BANKRUPTCY COURT
FOR THE NORTHERN DISTRICT OF CALIFORNIA

In re)	Case No. 08-30991 TEC
)	
WILLIAM JAMES DEL BIAGGIO, III,)	Chapter 11
aka "BOOTS" DEL BIAGGIO,)	
)	
)	
)	
Debtor.)	
_____)	

OPINION

The question presented is whether a creditor who obtains a partial recovery from a non-debtor co-obligor is required to reduce the claim asserted against the debtor in bankruptcy. I hold that the claim against the debtor is not reduced by the partial recovery, even if state law requires that the claim be reduced in a non-bankruptcy setting.

FACTS

William Del Biaggio, III (Debtor) borrowed a total of \$39.25 million from the six creditors whose claims are at issue here (Creditors). The loans were documented in promissory notes that Debtor represented would be secured by a pledge of shares of corporate stock held by Debtor at Merriman Curhan Ford & Co.

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1 (Merriman). Debtor provided the lenders copies of account
2 statements from Merriman showing Debtor to be the owner of the
3 shares.

4 In fact, Debtor did not own the shares pledged to secure the
5 loans. At the behest of Debtor, D. Scott Cacchione, a Merriman
6 employee, fabricated the account statements showing Debtor to be
7 the owner of the shares. Creditors learned of the fraud when
8 Debtor failed to repay the notes. Debtor and Cacchione were both
9 convicted of securities fraud, were sentenced to prison, and were
10 ordered to pay restitution.

11 Creditors sued Merriman, asserting that their losses resulted
12 from Merriman's negligence in hiring and supervising Cacchione, and
13 from Merriman's failure to maintain adequate controls.¹ The suit
14 against Merriman was settled, with Merriman paying Creditors a
15 total of \$6.9 million.

16 Creditors filed claims in Debtor's bankruptcy case, seeking
17 the full balance due on each of the notes without reduction for the
18 amounts received from Merriman.

19 The Official Committee of Unsecured Creditors (the Committee)
20 objected to Creditors' claims, contending that the amount of the
21 claim that each Creditor may assert against Debtor's bankruptcy
22 estate must be reduced by the amount the Creditor received from
23 Merriman (the Reduction-of-Claim Approach). Creditors contend that
24 the claims they assert in Debtor's bankruptcy case need not take
25 account of payments from co-obligors, unless the dividend paid in
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¹ Creditors sued Del Biaggio and Cacchione in the same action, but the action against those two individuals was stayed when they filed bankruptcy petitions.

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1 the bankruptcy case will result in a more than full recovery (the
2 Limitation-of-Dividend Approach).

3 The Supreme Court addressed this question in Ivanhoe Bldg. &
4 Loan v. Orr, 295 U.S. 243 (1935). In that case, the debtor owed
5 the claimant \$10,740. The claimant held an unsecured claim against
6 the debtor. The claim was also secured by real property owned by a
7 third party.² Prior to debtor's bankruptcy, the claimant had
8 foreclosed upon the secured claim and had recovered \$100 (the
9 amount the claimant bid at the foreclosure sale). Debtor's
10 bankruptcy trustee argued that debtor was entitled to offset the
11 value of the real property collateral (\$9,000), rather than the
12 \$100 bid for that property at the foreclosure sale. The bankruptcy
13 court agreed with debtor's trustee, reducing the claimant's
14 unsecured claim by the value of the real property collateral. The
15 district court and court of appeals affirmed.

16 The Supreme Court reversed, holding: (1) debtor was entitled
17 to a credit of only \$100 (the amount recovered through the pre-
18 petition foreclosure sale); (2) this credit would not reduce the
19 unsecured claim in debtor's bankruptcy case unless the claimant
20 would otherwise recover from all sources more than the full amount
21 due. The court stated that the claimant could properly assert the
22 proof of a claim "for the principal of the [debt] with interest,
23 though the petitioner may not collect and retain dividends which
24 with the sum realized from the foreclosure will more than make up
25 that amount." Id. at 245-46.

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28 ² The debtor originally owned the property and executed a
mortgage in favor of the claimant before transferring the property
to the third party.

1 The language quoted above is part of the holding of Ivanhoe,
2 because it had an effect upon the size of the distribution that the
3 bankruptcy court was directed to make to the creditor upon remand.
4 The quoted language directed the bankruptcy court to allow the
5 unsecured claim in the full amount of the debt owed the creditor.
6 Adopting the reasonable assumption that the debtor's bankruptcy
7 estate would not pay unsecured claims in full, the Court's
8 directive caused the creditor to receive a larger dividend than if
9 the creditor's unsecured claim had been reduced by the recovery
10 from the third party.³

11 The language from Ivanhoe quoted above is also binding
12 precedent under the current Bankruptcy Code. The Supreme Court has
13 stated "[w]hen Congress amends the bankruptcy laws, it does not
14 write 'on a clean slate.'" Dewsnup v. Timm, 502 U.S. 410, 419
15 (1992) (citations omitted). Congress is presumed to have enacted
16 the Bankruptcy Code of 1978 with an understanding of the holding of
17 Ivanhoe, and to have intended to incorporate that holding into the
18 Code, unless the language of the Code or its legislative history
19 clearly provides otherwise. Id. The Committee points to no
20 provision in the Code that adopts a mechanism for accounting for
21 payment by third parties different from that specified in Ivanhoe,
22 nor to any statement in the legislative history indicating that
23 Congress intended to overrule Ivanhoe.

24 The few decisions governed by the current Code that have
25 addressed the question have followed the approach specified in
26 Ivanhoe. The Fourth Circuit has stated "In Ivanhoe, the Supreme
27 Court held that a creditor need not deduct from his claim in

28 ³ The dividend to unsecured creditors in the present case is projected to be 7 to 13 percent of allowed claims.

1 bankruptcy an amount received from a non-debtor third party in
2 partial satisfaction of an obligation." In re Nat'l. Energy & Gas
3 Transmission, Inc., 492 F.3d 297, 301 (4th Cir. 2007).⁴ Citing
4 Ivanhoe, another court stated

5 We start with the proposition that members of an
6 unsecured creditors class may have rights to payment
7 from third parties, such as joint obligors, sureties
8 and guarantors, and these rights may entitle them to a
9 disproportionate recovery compared to other creditors
10 of the same class (up to a full recovery).

11 In re Journal Register Co., 407 B.R. 520, 533 (Bankr. S.D.N.Y.
12 2009). Accord Sec. Investor Protection Corp. v. Waddell Jenmar
13 Sec., Inc. (In re Waddell Jenmar Sec., Inc.), 126 B.R. 935, 947
14 n.12 (Bankr. E.D.N.C. 1991) (no reduction of claim in bankruptcy
15 for recovery from third party where no double recovery).

16 The Committee argues that Ivanhoe is not applicable, however,
17 because state law governs the existence and amount of claims, and
18 because California law specifies that a creditor's claim is reduced
19 by any amount recovered from a co-obligor in respect of the same
20 claim. This argument has an initial appeal. It is true that the
21 claims asserted in bankruptcy cases are generally defined by non-
22 bankruptcy law. Travelers Cas. & Sur. Co. of America v. Pac. Gas &
23 Elec. Co., 127 S. Ct. 1199, 1205 (2007). It is also true that
24 California law provides that payment by a co-obligor reduces the
25 amount of the claim the creditor can assert. See, e.g., Cal. Civ.
26 Proc. § 877; Brawley v. J.C. Interiors, Inc., 161 Cal. App. 4th
27 1126, 1133-34 (2008); May v. Miller, 228 Cal. App. 3d 404,

28 ⁴ The quoted statement may be *dictum*, because the court noted
a second reason that the claim in bankruptcy should not be reduced
by the amount of the third-party payment. The payment had been
made by a surety, and under state law no offset could be claimed on
the basis of a payment made by a surety. 492 F.3d at 301. The
Nat'l. Energy & Gas decision is discussed further in note 7, below.

1 409-10 (1991); Syverson v. Heitmann, 171 Cal. App. 3d 106, 110-11
2 (1985).

3 I conclude that the Reduction-of-Claim Approach utilized by
4 California courts outside of bankruptcy does not require this court
5 to depart from the Limitation-on-Dividend Approach adopted in
6 Ivanhoe for use in bankruptcy cases. This is so for the following
7 reasons.

8 First, Ivanhoe adopts a rule to deal with the situation in
9 which the defendant co-obligor is in bankruptcy and cannot pay his
10 debts in full. Ivanhoe makes a choice as to how the claim of a
11 creditor will be treated in bankruptcy proceedings if that creditor
12 receives partial payment from a co-obligor of the debtor. Ivanhoe
13 decides that the amount the creditor's claim in the bankruptcy case
14 is not affected by third-party payments, except to the extent
15 payment from the debtor would produce a double recovery. Ivanhoe
16 thus chooses to value equality of treatment by the debtor's estate
17 above equality of overall outcomes among creditors having different
18 rights against third parties.⁵ This choice is at heart a question
19 of federal bankruptcy law.

20 Second, the choice between the Reduction-of-Claim Approach and
21 the Ivanhoe Limitation-of-Dividend Approach matters only when the
22 defendant co-obligor is in bankruptcy. If the defendant co-obligor
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24 ⁵ Debtor argues that the Ivanhoe Limitation-of-Dividend
25 Approach violates the policy of the Bankruptcy Code that requires
26 creditors to be treated equally, citing Union Bank v. Wolas, 502
27 U.S. 151 (1991). Wolas does not support the Committee's argument,
28 because it cites the equality-of-distribution policy to explain the
preference statute, which seeks to equalize distribution made *by*
the debtor. The question presented here is whether that rule of
equal distribution by the debtor's estate should be abandoned when
a creditor can obtain a partial recovery from a *third party*.
Ivanhoe says no, and thereby furthers the concept of equality of
treatment by debtor described in Wolas.

1 is solvent, the Reduction-of-Claim Approach does not prevent the
2 plaintiff from obtaining a full recovery. But if the defendant co-
3 obligor is in bankruptcy and cannot pay his claims in full, the
4 choice effects the dividend the creditor will receive from the
5 bankruptcy estate. This effect is illustrated in the following
6 table.

Defendant Solvent, Does Not File Bankruptcy			Defendant Files Bankruptcy, Pays 50 Percent Dividend	
Rule	Reduction- of-Claim	Limitation- of-Dividend	Reduction- of-Claim	Limitation- of-Dividend
Amount of Joint Debt	100	100	100	100
Payment by Co-obligor	30	30	30	30
Remaining Claim	70	100	70	100
Payment by Defendant	70	70*	35	50
Creditor's Total Recovery	100	100	65	80
* Limited to 70 because creditor may not obtain double recovery				

22 Third, the California authorities utilizing the Reduction-of-
23 Claim Approach do not explain why that mechanism is to be preferred
24 when the defendant co-obligor is insolvent and in bankruptcy.⁶

26 ⁶ It is unlikely that the Reduction-of-Claim Approach would
27 produce a result different from the Limitation-of-Damages Approach
28 even if the defendant was insolvent, so long as the defendant did
not file bankruptcy. This is so because the plaintiff would have
access to all of the defendant's non-exempt, unencumbered property
until the debt was satisfied. If the debt was not paid in full, it
would be because the defendant's assets were insufficient, not

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1 Those authorities do not even mention insolvency, and seem tacitly
2 to assume that the defendant co-obligor will pay the full amount of
3 any judgment entered, thereby providing the plaintiff a full
4 recovery. Thus, the California authorities do not even purport to
5 address the question presented here.

6 Fourth, the choice between the Reduction-of-Claim Approach and
7 the Ivanhoe Limitation-of-Dividend Approach does not involve
8 general and basic rules regarding contractual and non-contractual
9 liability or property rights under state law. Rather, the present
10 choice involves only how claim payments are calculated where the
11 defendant is insolvent and in bankruptcy. Although Congress
12 generally refers to state law to determine the existence and amount
13 of a claim, Congress has broad power to modify the rights of
14 unsecured creditors, and the Committee cites no authority that
15 suggests that Congress did not or could not adopt the Ivanhoe rule
16 for calculating dividends to be paid by bankruptcy estates.⁷ The
17 only state policy or interest identified in the California cases
18 adopting the Reduction-of-Claim Approach is that the plaintiff
19 should not obtain a double recovery. Brawley, 161 Cal. App. 4th at

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21 because the claim had been reduced by payments from a co-obligor.
22 It is only upon the filing of a bankruptcy, which forces the
23 plaintiff to share the assets of the insolvent defendant with other
24 creditors, that the reduction of the claim makes a difference.

25 ⁷ The decision in Nat'l. Energy & Gas appears to rely on state
26 law to determine whether a creditor's claim in bankruptcy should be
27 reduced to account for a payment made by a co-obligor. 492 F.3d at
28 301. The state law the court cited provided that a debt not be
reduced by any amount paid by a surety. Id. In providing that the
claim not be reduced, state law did not conflict with Ivanhoe, and
the Nat'l. Energy & Gas decision therefore does not suggest that
state law can overcome Ivanhoe's determination that in bankruptcy
the policy of equality of distribution from the debtor is to
prevail over concern for equalizing creditor's recovery from all
sources. The court had previously held that Ivanhoe governed, and
its discussion of state law is at most an alternative holding. Id.

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1 1135; May v. Miller, 228 Cal. App. 3d at 410. The Ivanhoe
2 Limitation-of-Dividend Approach furthers that goal every bit as
3 reliably as the Reduction-of-Claim Approach.

4 In light of the four factors described above, I determine that
5 the California Reduction-of-Claim Approach is not intended to apply
6 to claims asserted in a federal bankruptcy case, and that Ivanhoe
7 states a rule of federal bankruptcy law that must prevail over any
8 contrary state law.⁸

9 CONCLUSION

10 The Committee's limited objection to Creditors' claims are
11 overruled. The amount of those claims need not be reduced by the
12 amounts received from co-obligor Merriman unless Creditors would
13 otherwise reap a double recovery.

14 ****END OF OPINION****

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⁸ In response to the Committee's objection to their claims,
25 Creditors raised several arguments that do not depend upon Ivanhoe
26 prevailing over contrary state law. Those arguments include the
27 following: (1) that the California statutes and decisions that the
28 Committee relies upon do not apply because the promissory notes are
governed by the laws of other states; (2) that the California
statutes and decisions do not require payments made by a joint tort
feasor to be offset against their breach-of-contract claim against
Debtor; and (3) Debtor waived all setoff rights. In light of my
determination that Ivanhoe governs, it is not necessary to address
Creditors' other arguments.

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